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The Municipality as Shareholder: Securities Litigation in the Age of Fiscal and Social Responsibility

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Securities litigation is often viewed as benefiting individual shareholders who have been harmed due to misstatements, omissions, negligence, or intentional acts of public companies. But the reality is that millions of others participate in the capital markets as employees of municipalities and local government subdivisions—counties, cities, townships, school districts, fire and police departments and more—who act on behalf of these workers as shareholders in publicly traded entities through pension plans, risk management pools and similar vehicles. As indicated in this article, these entities can add their influence to obtain recourse for corporate wrongdoing and to effect socially responsible change in corporate policies.

Overview:

Securities class action plaintiffs amassed $2 billion in settlements in 2019. An average of 224 new federal securities class actions were filed each year between 1997 and 2019, with 428 filed in 2019 alone.[1] In fact, the total financial recovery from settled securities class actions in roughly that same time frame, 1996 to present, is $104,371,151,287 – yes, over $104 billion.[2] In securities class actions, plaintiffs bring a suit as a class seeking compensation from defendants for damages resulting from a loss in a stock's value. Often, the same core underlying facts that support a securities class action can give rise to a shareholder derivative lawsuit in which shareholders sue corporate executives and board members on behalf of the company itself, seeking damages to be returned to the corporate entity as well as corporate governance reforms. In each instance, municipal entities often take the role of lead litigant. Recently, shareholder derivative cases have brought about meaningful governance reforms in the wake of social, environmental and public health wrongs. Institutional investors, including state and municipal entities that collectively hold more than $4 trillion in public company securities,[3] have played a significant role in bringing these settlements to fruition.

What Is a Securities Fraud Class Action

A securities class action is a case brought pursuant to Federal Rule of Civil Procedure 23 on behalf of a group of persons and entities who purchased the securities of a particular company during a specified period of wrongdoing (the class period). The complaint generally contains allegations that the company and/or certain of its officers and directors violated one or more federal or state securities laws. A suit is filed as a class action because the members of the class of impacted investors are so numerous that joinder of all members is impracticable. For a case to proceed as a class action, there should be a well-defined commonality of interest in the questions of law and fact involved in the case. Further, the plaintiffs must establish that a class action is superior to other available methods for the fair and efficient adjudication of the controversy and that the prosecution of separate actions by individual class members would create a risk of inconsistent and varying adjudications.

Securities fraud deprives individual investors, retirement plans, pension funds, and institutional investors out of millions of dollars every year. Manipulation of the market for a given stock is actionable under the federal securities laws. The past paradigms for these cases are steeped in allegations of accounting fraud and earnings restatements as in *Enron* and *WorldCom*.

What Is A shareholder Derivative Action? Corporate Governance Goals

Unlike a securities fraud class action, which is brought on behalf of investors to recoup monetary loss, a shareholder derivative action is a lawsuit brought by a shareholder of a publicly traded company on behalf of and for the benefit of the company itself against the directors and/or officers of that company. In a derivative action, shareholders "step into the shoes" of the directors and officers of a company and bring litigation that the corporate board would be unwilling to pursue on its own. Such unwillingness typically relates to the fact that the board members themselves are alleged to have participated in the misconduct and thus would be unlikely to "sue themselves."

Shareholder derivative litigation can recover money damages back to the company for financial or reputational harm caused by the conduct of its insiders, and also can be used to improve the governance of public companies in order to guard against such harms in the future.

Any shareholder of a company can be a nominal plaintiff in a shareholder derivative action provided that the shareholder has held stock in the company continuously from at least the period in which the alleged wrongful conduct began through the present.

What Laws Provide Shareholder Derivative Standing

Shareholder derivative actions generally arise out of violations of state corporation laws and as such, are traditionally brought in state courts. However, shareholder derivative actions can be brought in federal court under certain circumstances. Under Delaware state law, which governs a majority of U.S. companies that are incorporated there and also serves as a model for other state laws, directors and officers of publicly traded companies owe fiduciary duties to the companies that they serve. These duties include the duties of:

- **Loyalty,** which requires directors and officers not to use their positions of trust and confidence to further their private interests;

- **Care,** which requires that directors use that amount of care which ordinarily careful and prudent people would use in similar circumstances;

- **Good Faith,** which requires corporate fiduciaries to act with a genuine attempt to advance corporate welfare — not to act in a manner unrelated to a pursuit of the corporation's best interests.

Breaches of these three duties form the foundation of the claims underlying shareholder derivative actions.

What Harm Is Required to Bring A Shareholder Derivative Action?

The harm alleged by the nominal plaintiff *must be to the company itself,* and not to the shareholder personally. Moreover, because company officers and directors are traditionally charged with preserving the interests of the company, a shareholder in a derivative action must be able to demonstrate that a litigation demand on the board to pursue the action was either wrongfully refused, or that making a litigation demand prior to filing suit would have been futile due to the self-interest of the members of the board.

While accounting fraud-based allegations often come to mind when thinking of securities class action litigation, in the last several years, there has been a trend toward filing event or social justice-based securities litigation in the class and derivative context. Some of the more newsworthy are detailed below.

Newsworthy Examples Related to Gender and Race Discrimination.

In re Alphabet Shareholder Derivative Litigation, 19-CV-341522 (Cal. Super. 2020) – A shareholder derivative lawsuit against Alphabet and top current and former executives alleged that the company misled investors by covering up sexual harassment and abuse by executives, along with a Google+ data breach. Among the nominal plaintiffs in this matter was the City of Irving (Texas) Firemen's Relief & Retirement Fund.

The lawsuits generally alleged that Alphabet's board engaged in a "pattern of concealment" to protect company interests at investors' expense, including the concealment of sexual misconduct and lax customer data safeguards. The investors pointed to $135 million in combined severance payouts to former executives Andy Rubin and Amit Singhal, who left the company following credible sexual harassment allegations.

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In response to the litigation, Alphabet agreed to create a special litigation committee to investigate the claims. After its investigation, the committee presented its results to the parties before they entered into a settlement. Under the settlement, Alphabet agreed to allocate $310 million over up to 10 years to fund various initiatives meant to diversify its workforce from top to bottom, including investing in computer science programs and hiring underrepresented talent. The settlement also creates an anti-sexual harassment program that includes a commitment to transparency and to fostering a respectful working environment. Alphabet is required to incorporate these principles into formal policies and to create a panel — named the Diversity, Equity and Inclusion Advisory Council — to oversee its efforts for at least five years.

Additionally, Alphabet has agreed to more closely monitor data breaches and to make "sweeping policy reforms" that include ending the use of forced arbitration of harassment, discrimination and retaliation-related employment disputes, narrowing confidentiality agreements so that workers can discuss the facts of their case, and ensuring that workers company-wide are punished equally for the same misconduct.

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Similarly, in *City of Monroe Employees' Retirement System v. Rupert Murdoch et al.*, 2017-0833-AGB, (Del. Chanc. 2017), 21st Century Fox agreed to a $90 million settlement (to be funded by insurance) to resolve allegations by the City of Monroe (a shareholder) that the company's management permitted a culture of sexual and racial harassment to permeate the company, ultimately resulting in financial and reputational harm to the company. The settlement included not only a financial component, but also provisions for corporate governance and compliance enhancements, including the creation of a Workplace Professionalism and Inclusion Council.

The shareholder derivative lawsuit related to underlying allegations that numerous women who worked for the company had been sexually or racially harassed or retaliated against. In July 2016, former Fox News reporter Gretchen Carlson had filed a sexual harassment and wrongful termination suit, alleging that Fox News CEO Roger Ailes had harassed and retaliated against her. Her allegations led to an internal investigation of Ailes, which in turn led to his departure from the company pursuant to a separation agreement under which Ailes was paid substantial sums. Shortly thereafter, the City of Monroe Employees' Retirement System filed a books and records request with the company seeking documents relating to Carlson's allegations and Ailes's separation from the company.

The complaint contained six separate claims for relief, alleging breach of fiduciary duty against the individual defendants and unjust enrichment against the estate of Roger Ailes. (The unjust enrichment count related to the separation payments the company agreed to pay Ailes at the time of his departure from the company). The complaint alleged the existence of a "systemic, decades-long culture of sexual harassment, racial discrimination, and retaliation that led to a hostile work environment at Fox News Channel." The hostile environment was "created and facilitated by senior executives at Fox News." The company's board, the complaint alleged, "did not take steps to address workplace issues such as sexual harassment and racial discrimination" and "failed to implement controls sufficient to prevent the creation and maintenance of this hostile work environment."

The complaint further alleged that the company's senior officials "failed to implement sufficient oversight over the workplace" at Fox News to "prevent massive damage to the Company." The company's top executives allegedly failed to meet their "fiduciary duty to monitor developments at its most important business unit, investigate when red flags appeared, or put in place protocols that would have ensured greater visibility into the hostile work environment at Fox News."

Public revelations of a "toxic work culture" led to "numerous sexual harassment settlements and racial discrimination lawsuits" and to the "departures of talent and damage to good will." Among other things, the complaint alleged that the Company paid over $55 million in sexual harassment and racial discrimination settlements. The complaint also alleged that the toxic work culture the senior management permitted also caused the company other harm, including the severance or termination payments the company agreed to pay to Ailes and O'Reilly as well as approximately $20 million in related litigation defense costs and over $200 million in related financial harm.

The settlement provided both a payment to the Company of $90 million and the implementation of governance and compliance reforms which included the creation of the Fox News Workplace Professionalism and Inclusion Council comprised of "experts in workplace and inclusion matters" to advise Fox News and its management "in its ongoing efforts to ensure a proper workplace environment for all employees and guests," as well as to improve reporting, workplace behavior, and recruitment of women and minorities.

New York State Common Retirement Fund Amazon Audit. On December 18, 2020, the New York State Common Retirement Fund (NYSCRF) announced that it had filed a shareholder proposal calling for an independent audit to assess Amazon.com Inc.'s policies and practices on civil rights, equity, diversity, and inclusion. The proposal requests that Amazon's "Board of Directors commission a racial equity audit analyzing Amazon's impacts on civil rights, equity, diversity and inclusion, and the impacts of those issues on Amazon's business. The audit may, in the board's discretion, be conducted by an independent third party with input from civil rights organizations, employees, communities in which Amazon operates and other stakeholders."[4] NYSCRF's proposal cites a host of concerns that appear inconsistent with Amazon's pledge to fight systemic racism including reports of payment of low wages to disproportionately Black and Latino warehouse employees, who have contended with dangerous conditions such as exposure to COVID-19, racial discrimination against a former employee who led a walkout over concerns of workplace safety, discrimination against employees for wearing Black Lives Matter masks on the job, inconsistent enforcement of Amazon's policy banning the sale of products that promote hatred, and the use of AWS facial surveillance technology disproportionately against people of color, immigrants, and civil society groups.[5]

Additional shareholder derivative actions alleging race and /or gender discrimination have been brought against the boards of Oracle, Pinterest, Qualcomm, CBS, Papa John's, Wynn Resorts, Lululemon, and Nike.

Newsworthy Examples Related to the Opioid Epidemic:

In re McKesson Corporation Derivative Litigation, 4:17-cv-01850 (N.D. Cal. 2017) McKesson Corp. directors agreed to pay $175 million to resolve a shareholder derivative action accusing the pharmaceutical distributor's board of failing to enforce a compliance program to catch suspicious orders of opioids, leading to a $150 million fine from the U.S. Department of Justice.

The shareholder derivative action accused current and former McKesson directors of breaching their fiduciary duties to the company by allowing it to violate the Controlled Substances Act even after paying a $13.25 million penalty in 2008 related to similar violations in which the DOJ alleged that the distributor had failed to design or implement an effective system to find and catch suspicious orders for controlled substances from its independent and small-chain pharmacy customers. McKesson assured the DEA that it would enforce a compliance program to catch suspicious orders, but the DOJ later discovered that McKesson never implemented the compliance program it had designed after the 2008 settlement.

Shareholders filed a shareholder derivative suit against the retired McKesson CEO and board Chairman along with several other current and former directors who served on the board around the time of either the 2008 agreement, the 2017 fine, or both.

"McKesson's board and senior executives knew that continued illegal and improper conduct could subject the company and its stockholders to grave consequences, including large fines and penalties and suspension of sales in lucrative markets," the complaint stated. "Despite these risks and red flags, the board and senior management threw the dice to see if the rewards from the improper conduct outweighed the negative consequences of being caught ignoring the mandate of the [controlled substance monitoring program] and the CSA."

In addition to the $175 million cash payment, the settlement included governance reforms that required a separation of the CEO and chairman roles, which were previously held jointly by the same person, term limits for directors, the addition of two new independent directors and an overhaul of McKesson's compliance committee.

Additional shareholder derivative actions stemming from alleged corporate wrongdoing and the opioid crisis have been brought against AmerisourceBergen and others.

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Social Responsibility *cont'd from page 15*

Newsworthy Examples Related to Data Breaches:

In re Equifax, Inc. Derivative Litigation, 1:18-CV-00317-TWT (N.D. Ga. 2018). Nominal plaintiffs included the Boston Retirement System.

The consolidated shareholder derivative complaint alleged claims derivatively on behalf of Equifax against the individual defendants for breach of fiduciary duties, unjust enrichment, waste, insider trading, and violations of the federal securities laws. Lead plaintiffs sought, among other things, monetary damages and the implementation of corporate governance and internal control reforms to prevent or at least to mitigate the risk of recurrence of the data breach.

Here, the class and derivative actions settled in tandem yielding a $149 million deal to end the securities fraud suit on behalf of a putative class of Equifax investors related to the credit reporting agency's massive 2017 data breach and a $32.5 million deal in a derivative shareholder suit stemming from the same incident and underlying facts.

Shareholder derivative litigation in the wake of a significant data breach has now become commonplace. In recent years, shareholders have filed derivative lawsuits in the aftermath of data breaches at Yahoo, Target, Home Depot, Wyndham, Wendy's, and others.

Newsworthy Examples Related to Covid

In re Inovio Pharmaceuticals, Inc. Derivative Litigation, 2:20-cv-01962 (E.D. Pa. 2020). Here, Inovio shareholders filed complaints against the company's CEO, the company's board chair, five other company directors and listed the company itself as a nominal defendant. The allegations are that defendants represented to the investing public, in statements by the CEO and in company SEC filings, that the company had developed a COVID-19 vaccine that could be ready for human trials as early as April 2020. These false statements caused the company's share price to rise, and later fall as the truth was revealed.

The shareholder derivative complaints allege that the defendants breached their fiduciary duties by making or causing the company to make the allegedly misleading statements, and by failing to correct or failing to cause the company to correct those allegedly false and misleading statements. The complaint also alleges that the defendants breached their fiduciary duties by failing to maintain internal controls. These failures subjected the company to a securities class action lawsuit as well as the need to conduct internal investigations, the need to implement adequate internal controls, and recoup losses from alleged waste of corporate assets as well as losses from the unjust enrichment of individual defendants who allegedly were over-compensated or benefited from the alleged wrongdoing. The complaints assert claims for breach of fiduciary duty, unjust enrichment, abuse of control, gross mismanagement, waste of corporate assets, and for contribution.

To date, at least 25 securities cases have been filed for (1) misrepresentation or failure to disclose risks associated with COVID-19, (2) statements about how COVID-19 is impacting the business operations of the company, or (3) false statements about COVID-19.[6] These cases have been filed against a variety of travel, health care, technology and financial services companies and are all still in their preliminary stages. The boards of publicly traded companies will continue to face both shareholder class action and derivative suits, and municipal involvement will play a significant role. *See, e.g. City of Riviera Beach General Employees Retirement System. v. Royal Caribbean Cruises LTD*, 20-CV-24111 (S.D. Fla. 2020) (alleging defendants failed to disclose material facts about the Company's decrease in bookings outside China, instead maintaining that it was only experiencing a slowdown in bookings from China. The complaint further alleges that defendants failed to disclose material facts about the Company's inadequate policies and procedures to prevent the spread of COVID-19 on its ships).

Additional shareholder derivative suits have been brought recently against corporate boards for failures in proper governance with respect to environmental abuses and money laundering.

Conclusion:

Shareholder litigation of the nature mentioned above is becoming increasingly more common. 2020 saw a large number of securities matters being filed, and even new legislation based on the social mores and issues of our day. In fact, on September 30, 2020, driven in part by renewed focus on equality and diversity issues, California enacted Assembly Bill 979, requiring public companies headquartered in California to elect at least one director from an underrepresented community by the end of 2021 and to have a minimum of two directors from underrepresented communities in companies with more than four but fewer than nine directors. A company with nine or more directors must have a minimum of three directors from underrepresented communities by the end of 2022.[7]

These shareholder cases and their results thus far represent a significant example of the influence that municipal and individual shareholders can have in demanding remedial measures to address toxic corporate culture concerns and the bad acts of corporate executives.

Municipal entities are increasingly recognizing their ability to influence social change through demanding better corporate governance from the companies in which invest. They may not only seek recovery of losses due to securities fraud, but can also propel social objectives via shareholder derivative matters in which a municipal entity who holds relevant securities can investigate a company and its board, and even bring litigation, for potential wrongdoing, mismanagement, and breaches of fiduciary duties for activities ranging from environmental wrongdoing, money laundering, to systemic racial and gender inequality and more.

Notes

1. *See* http://securities.stanford.edu/research-reports/1996-2019/Cornerstone-Research-Securities-Class-Action-Filings-2019-YIR.pdf
2. http://securities.stanford.edu/stats.html
3. https://www.urban.org/policy-centers/cross-center-initiatives/state-and-local-finance-initiative/projects/state-and-local-backgrounders/state-and-local-government-pensions#question1
4. https://www.osc.state.ny.us/files/press/pdf/ny-state-common-racial-equity-audit.pdf. *See also*, https://www.osc.state.ny.us/press/releases/2020/12/nys-comptroller-dinapoli-amazon-must-ensure-its-business-not-adding-racial-inequality
5. *See* https://www.osc.state.ny.us/press/releases/2020/12/nys-comptroller-dinapoli-amazon-must-ensure-its-business-not-adding-racial-inequality
6. *See* http://securities.stanford.edu/current-topics.html
7. AB-979 defines a "director from an underrepresented community" as "an individual who self-identifies as Black, African American, Hispanic, Latino, Asian, Pacific Islander, Native American, Native Hawaiian, or Alaska Native, or who self identifies as gay, lesbian, bisexual, or transgender." Companies may increase the size of their boards in order to comply with the law. AB-979 builds on California's AB-826, signed into law in 2018, which requires at least one woman to sit on any corporate board with its principal offices located in California. As a penalty for noncompliance, AB-979 allows California's secretary of state to impose fines in the amount of $100,000 for a first violation or failure to timely file board member information pursuant to AB-979, and $300,000 for any subsequent violation. ML